Capital Gains Taxes and the Market Response to Public Information

A thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy

By

Mahmoud Odat
School of Accounting
University of Technology, Sydney (UTS)
Australia

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Certificate of Authorship/Originality

I certify that the work in this thesis has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research work and the preparation of the thesis itself has been acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

Signature of Student

M. Oclut

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Abstract

In this thesis I theoretically investigate the impact of capital gains taxes on the market response to public information. There are two objectives: First, I employ the model in Shackelford and Verrecchia (2002) to investigate the extent to which differential tax rates on short and long-term capital gains and losses affect equilibrium price and trading volume response to public information disclosure (both 'good' and 'bad news') about the value of a risky asset. Second, I examine whether capital gains taxes affect the information content of equilibrium prices with respect to public information disclosures. In particular, I modify the Shackelford and Verrecchia (2002) model to include exogenous random supply of the risky asset and examine whether asymmetric tax treatment of short and long-term capital gains and losses affects the extent to which market prices reflect public information about the value of the risky asset.

The results indicate that differential tax rates cause equilibrium prices to be more sensitive to public information disclosures. In addition, they result in lower (higher) trading volume around public disclosures when there is a price increase (decrease) due to the magnified tax costs (benefits) associated with realizing a short-term gain (loss). Moreover, differential tax rates cause prices to be, on average, more sensitive to exogenous noisy supply of the risky asset. The results also suggest that the noise effect outweighs the information effect so that prices are, on average, more volatile and less informative with respect to public information.

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